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In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, TRUSTEE IN REORGANIZATION OF WEBB & KNAPP, INC., ETC., PETITIONER

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION[1]

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[1] The Securities and Exchange Commission is participating in the reorganization proceeding in the district court as a party pursuant to Section 208 of Chapter X of the Bankruptcy Act, 11 U.S.C. 608, and has taken positions in that court and in the court of appeals similar to the positions urged herein. As in *Protective Committee* v. *Anderson*, 390 U.S. 414, 420 n. 3, the Commission is "an unnamed respondent before this Court." See Rule 21(4) of the Rules of this Court.

OPINIONS BELOW

The opinion of the court of appeals (App. 84a-96a) is reported at 439 F. 2d 118. The opinions of the district court (App. 58a-61a, 62a-66a, 67a-70a) are not reported.

JURISDICTION

The judgment of the court of appeals was entered on March 3, 1971 (App. 82a). The petition for a writ of certiorari was filed on May 29, 1971, and granted on December 7, 1971. The jurisdiction of the Court rests on 28 U.S.C. 1254(1) and 11 U.S.C. 47c and 521.

QUESTION PRESENTED

Whether the reorganization trustee of a debtor in a proceeding under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, has standing, on behalf of a class of public investors holding debentures of the debtor, to prosecute their claims against their indenture trustee for willful misconduct or gross negligence in failing to enforce certain covenants of the debtor in the trust indenture, irrespective of whether such covenants related to specific property of the debtor.

STATUTES INVOLVED

The pertinent provisions of Sections 115, 167 and 187 of Chapter X of the Bankruptcy Act (11 U.S.C. 515, 567 and 587) and Section 315 of the Trust Indenture Act of 1939 (15 U.S.C. 77*ooo*), are set forth in an appendix to this brief, pp. 31-34, *infra*.

STATEMENT

This case involves the efforts of petitioner, appointed under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, as trustee in reorganization of Webb & Knapp, Inc., to assert claims on behalf of holders of debentures issued to the public by Webb & Knapp against Marine Midland Grace Trust Company of New York ("Marine"), as trustee under an indenture pursuant to which the debentures were issued. The court of appeals held that petitioner lacked standing to pursue these claims since, in the court's view, no property of Webb & Knapp or other "res" was involved and any successful prosecution of the suit would not affect the reorganization of Webb & Knapp.

A. Backround

The Chapter X proceeding was initiated in May 1965, when Marine filed a petition in the district court seeking the involuntary reorganization of Webb & Knapp. The petition was approved and petitioner was appointed trustee (Rep. 2).[2] The Securities and Exchange Commission entered an appearance pursuant to Section 208 of Chapter X, 11 U.S.C. 608, and has actively participated in the proceeding.

Webb & Knapp and its numerous subsidiaries had been engaged in widely diversified real estate activities in the United States—principally New York

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[2] "Rep." refers to the report of the Chapter X trustee, prepared pursuant to Section 167 of Chapter X, 11 U.S.C. 567, and dated January 30, 1970.

City—and Canada (Rep. 15; App. 44a). Petitioner's accountants completed an audit of Webb & Knapp's books which showed that shortly after the Chapter X proceeding was begun, the company had total assets of $21,558,621 and total liabilities of $60,036,164, plus contingent tax liabilities of $29,400,000 (Rep. 98). Included in its liabilities were 5% Sinking Fund Debentures in the principal amount of $4,298,200 plus interest subsequent to the inception of the proceeding *(ibid.)*.

In June 1966, Marine, acting pursuant to Section 198 of Chapter X, 11 U.S.C. 598, filed a proof of claim in the district court on behalf of the debenture holders of $4,298,200 (App. 30a). In addition, Marine filed a proof of claim on its own behalf of $51,447.55, which it asserted was due it for services rendered and for disbursements and expenses incurred as indenture trustee (App. 30a-31a).

B. The Trust Indenture

In June 1954, Webb & Knapp and Marine executed a Trust Indenture providing for the issuance by Webb & Knapp of the 5% Sinking Fund Debentures, due June 1974, in the aggregate principal amount of $8,607,600 (App. 30a). In the indenture, which was qualified under the Trust Indenture Act of 1939 (15 U.S.C. 77aaa, *et seq.*) *(ibid.)*, Webb & Knapp made certain covenants and agreements to and with Marine for the benefit of the holders of the debentures to be issued under the indenture; Marine, on its part, undertook to perform certain duties and to use due

care in the exercise of its rights and powers under the indenture (App. 45a).

Specifically, Webb & Knapp covenanted in Section 3.6 of the indenture that neither it nor its consolidated subsidiaries would incur or assume certain indebtedness or purchase any real property or interests in real property, unless prior to such transaction the company's consolidated tangible assets, as defined in the indenture, equaled 200 percent of certain liabilities, after giving effect to the contemplated indebtedness or purchase (the "2 to 1 ratio") *(ibid.)*. Under Section 3.11, Webb & Knapp covenanted to file with Marine annually a certificate signed by responsible officers stating whether the company had defaulted on any of its covenants or agreements under the indenture during the preceding year (App. 45a-46a). Under Section 10.1(b) of the indenture, Marine was to be liable for its negligence or willful misconduct, except that it was entitled, in the absence of bad faith, to rely on certificates submitted to it which conformed to the requirements of the indenture.

C. Petitioner's Investigation and Claims Against Marine

Pursuant to Section 167 of Chapter X, 11 U.S.C. 567, petitioner, upon appointment as the Chapter X trustee, undertook an extensive investigation of the affairs of Webb & Knapp (Rep. 62, 65). As a result of that investigation, several suits were instituted, including a suit by petitioner against William Zeckendorf—Webb & Knapp's chief executive officer since 1942—and others, charging waste and mismanage-

ment of corporate assets and seeking substantial damages (Rep. 3, 63). In addition, petitioner reported that it was his opinion that Marine had either willfully or negligently failed to fulfill its obligations under the indenture (Rep. 65).

Petitioner requested and obtained an order from the reorganization judge authorizing him to commence an action against Marine "for the recovery of the damages sustained by virtue of the grossly negligent performance of its fiduciary obligations" (App. 41a). Petitioner asserted this claim both in an independent plenary action filed in the district court (App. 43a-48a) and in a counterclaim to Marine's claim for certain services (App. 49a-53a). In addition, petitioner moved in the reorganization proceeding that Marine be required to file an accounting (App. 42a).

In particular, petitioner alleged that from 1954 to 1964, Webb & Knapp's officers had prepared and submitted to Marine at Marine's request appraisals of Webb & Knapp's assets for the purpose of satisfying Marine that the 2 to 1 ratio of assets to liabilities required by Section 3.6 of the indenture was being maintained (App. 46a). Petitioner further alleged that these appraisals were fraudulent, in that they contained grossly overstated valuations of certain real estate properties owned by Webb & Knapp, and that at no time from 1958 through 1964 did Webb & Knapp comply with its covenant to maintain the 2 to 1 ratio (App. 46a-47a). Petitioner alleged that Marine knew or should have known that the appraisals were inflated, that Webb & Knapp was suf-

fering serious financial losses during the period, and that as a result the 2 to 1 ratio was not being maintained (App. 47a).[3] Webb & Knapp allegedly entered into countless transactions prohibited by Section 3.6 of the indenture because of the impaired assets-to-liabilities ratio, with the result that its net worth declined from $25,066,657 as of December 31, 1958, to a deficit of $38,500,000 when the Chapter X petition was filed in May 1965 (App. 47a-48a).

Finally, petitioner alleged that the failure of Marine to enforce the 2 to 1 ratio covenant "either constituted willful misconduct or gross negligence in violation of its [own] obligations as Indenture Trustee" (App. 48a). Damages were sought on behalf of the debenture holders of $4,298,200, the aggregate principal amount of the debentures at the time the reorganization proceeding was instituted, together with interest (App. 48a).

D. The Decisions of the Courts Below

The district court dismissed the complaint filed in the plenary action on the ground that petitioner lacked standing to assert the claim against Marine under the Second Circuit's decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, since no property of Webb & Knapp was involved (App. 58a-61a). A second order dismissed the trustee's counterclaim to Marine's $51,448 claim for services on the same

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[3] Beginning in 1958, Webb & Knapp sustained losses in every year but one, ranging from $1,026,484 in 1959 to $19,625,151 in 1962 and $32,320,953 in 1968, the year of Webb & Knapp's last audited report (App. 39a-40a).

ground (App. 64a). In the same order, Marine's motion to strike petitioner's objection to the claim for services was denied (App. 66a), thus allowing petitioner to assert his contention that Marine failed to carry out its obligations under the indenture, but only as an affirmative defense. Finally, in a third order, the district court denied petitioner's motion to compel Marine to file an accounting (App. 67a-70a).

On consolidated appeals, the court of appeals, in an *en banc* decision, followed its earlier decision in *Clarke* and affirmed the district court's orders (App. 85a-96a). The court denied petitioner standing on the ground that the asserted claim against Marine did not involve Webb & Knapp's property or a trust "res." Judges Kaufman and Hayes dissented in part, stating that they would overrule *Clarke* and permit petitioner to assert the counterclaim and maintain the plenary action (App. 96a-102a).

The court was unanimous in affirming the district court's denials of petitioner's motion for an accounting and Marine's motion to strike petitioner's objection to Marine's claim for services (App. 95a-96a).[4]

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[4] While Marine had cross-appealed to the court of appeals (App. 80a, 85a), it did not seek review in this Court of the court of appeals' affirmance of the denial of its motion. Accordingly, no issue is presented here with respect to the correctness of the ruling of the district court that petitioner may assert his contention that Marine failed to carry out its obligations under the indenture as a defense to Marine's claim for services.

SUMMARY OF ARGUMENT

The court below denied standing to petitioner, as trustee under Chapter X of the Bankruptcy Act, to sue Marine on behalf of the debtor's debenture holders on the ground the indenture trustee's activities had not adversely affected the debtor's "property" or a trust "res." In thus narrowly restricting the functions and powers of the Chapter X trustee, the court below failed to heed the mandate of this Court that legislation enacted for the protection of investors should be construed flexibly to effectuate its broad remedial purposes rather than technically or restrictively. Cf. *Securities and Exchange Commission* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195.

1. Both Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, and the Trust Indenture Act of 1939, 15 U.S.C. 77*aaa*, *et seq.*, were enacted following a comprehensive study by the Securities and Exchange Commission disclosing the lack of protection afforded public security holders either by the trustees under the indentures pursuant to which their securities were issued or in the reorganization proceedings which followed the insolvency of an issuer of such securities. A major concern of Congress in enacting the statutes was thus to protect public investors and provide them with a "focal point" for asserting their common interests in the reorganization process. The Trust Indenture Act provided bondholders with independent indenture trustees with powers and duties designed to enable and compel them vigorously to protect the bondholders' rights under indentures;

Chapter X provided for the appointment of a disinterested reorganization trustee with broad powers to investigate a debtor's affairs, formulate a plan of reorganization and generally to exercise the powers of a receiver in equity.

2. In keeping with the underlying purpose of Chapter X to protect public investors, the Chapter X trustee is the appropriate individual to investigate the performance of an indenture trustee's duties under an indenture pursuant to which a debtor's debentures were issued and to pursue on behalf of the debenture holders any causes of action disclosed by the investigation. The individual debenture holders may be ignorant of their rights and may not have the resources, either acting alone or in concert, successfully to prosecute an action against the indenture trustee. Moreover, since, as here, the Chapter X trustee may have to investigate and develop the facts surrounding alleged misconduct by an indenture trustee in response to claims asserted by the indenture trustee in the reorganization proceeding, the fostering of private suits based on the same conduct may result in an unnecessary duplication of fact-finding.

3. The court below, in following its earlier decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, unduly restricted the powers of the Chapter X trustee. By distinguishing later cases which had substantially limited the effect of the *Clarke* decision, the court imposed an artificial distinction, having no basis in logic or policy, between causes of action a reorganization trustee can maintain against an in-

denture trustee and those he cannot. The court also failed to appreciate the considerable effect that recovery by petitioner on behalf of the debenture holders would have on the reorganization process, whether or not Marine would be subrogated to the claims of the debenture holders against the estate of Webb & Knapp.

ARGUMENT

A CHAPTER X TRUSTEE HAS STANDING TO MAINTAIN AN ACTION ON BEHALF OF PUBLIC INVESTORS HOLDING DEBENTURES ISSUED BY THE DEBTOR AGAINST THEIR INDENTURE TRUSTEE FOR BREACH OF ANY FIDUCIARY DUTY OWED THEM UNDER THE INDENTURE

A. As the Legislative History and Provisions of Chapter X Make Clear, the Chapter X Trustee Is Invested with Broad Powers to Protect the Interests of Public Investors in a Debtor

This Court has noted that "in enacting Chapter X Congress had the protection of public investors * * * primarily in mind." *Securities and Exchange Commission* v. *American Trailer Rentals Co.*, 379 U.S. 594, 614. Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, enacted in 1938, stemmed from the same comprehensive study[5] conducted by the Securities and Exchange Commission, disclosing widespread abuses under the then existing reorganization procedures, that led the following year to the enactment of the Trust Indenture Act of 1939, 15

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[5] Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees* (hereinafter, "Study").

U.S.C. 77aaa, *et seq.* See II Loss, *Securities Regulation* 719 (2d ed., 1961). The two statutes together were intended to alleviate the unfortunate position that many public investors were in prior to 1938: the Trust Indenture Act by giving indenture trustees vastly increased powers and duties; Chapter X by empowering the disinterested Chapter X trustee to serve as a focal point for asserting the interests of the investors in the reorganization process.

The Commission's study focused in the main on the lack of investor protection in the reorganization process, and considered specifically the unsatisfactory performance of many indenture trustees. The study found that by and large the indenture trustee had been controlled by the management of the company issuing securities under the indenture and the bankers. Study, pt. I, at 329. This dominance resulted not only from direct control of indenture trustees through corporate affiliations such as interlocking directorates, but also from the fact that indenture trustees were under no meaningful contractual obligation to assume an active role—although they had the power to do so[6]—in the protection of investors

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[6] In Part VI of the study, the Commission noted (at p. 4):

> [T]ypically the [indenture] trustees do not exercise the elaborate powers which are the bondholders' only protection; * * * they have taken virtually all of the powers designed to protect the bondholders, but have rejected any duty to exercise them; and * * * they have shorn themselves of all responsibilities which normally trusteeship imports. The "so-called trustee" which is left is merely a clerical agency and a formal instrument which can be used by the bondholders when and if enough of them combine as specified in the indenture.

even after the issuing company defaulted on its obligations (*id.* at 333). The Commission recommended that indenture trustees "be transformed into active trustees with the obligation to exercise that degree of care and diligence which the law attaches to such high fiduciary position." Study, pt. VI, at 110.

The study also noted that the average security holder was in an almost helpless situation in reorganizations, both as a result of his probable inexperience in the complex aspects of corporate finance and law and as a result of the fact that the pursuit of his rights would involve expenditures greatly out of proportion to the amount of his investment. Study, pt. II, at 1. Because it found the existing reorganization procedures inadequate to relieve the individual investor from this unenviable position the Commission recommended that the whole reorganization process be refashioned so that "primary emphasis be given to the protection of the interests of investors." Study, pt. I, at 897.

Specifically, the Commission recommended that a qualified and disinterested reorganization trustee be appointed in virtually all corporate reorganizations to "supplant the system of leaving the debtor in possession or of appointing 'friendly' trustees" (*id.* at 899). In the Commission's view *(ibid.)*:

> Greater assurance would be provided that the public interest, no less than the immediate interests of creditors and stockholders, would be served by removing * * * [control of the reorganization process] from those whose interests are frequently incompatible with the interests of investors.

The plight of individual investors in reorganization proceedings was again a subject of concern at the Hearings before the House Judiciary Committee on the bill which eventually became the Chandler Act, revising the predecessor of Chapter X.[7] Then Commissioner, now Mr. Justice, Douglas testified on behalf of the Commission that (House Hearings, pp. 163, 164):

> There is, admittedly, a widespread and national investor interest in these reorganization proceedings. Certainly in the larger cases the securities are widely held. The holdings are small, and individual action by the security holders, to protect themselves, is, in many cases, out of the question. They either lack the funds, or the skill, the acumen or the initiative to take matters into their own hands. They are frequently without any adequate representation in the proceedings. Even should they desire to organize for mutual protection, they normally will find that the lists of their fellow security holders are not readily available. They are at the mercy of the inside groups—the management and the investment bankers. And the records show that these inside groups frequently have objectives which are incompatible with the objectives of investors. They are interested in concealing claims for fraud or mismanagement; investors are interested in collecting on those claims. * * *
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[7] Hearings on H.R. 6439 Before the House Committee on the Judiciary, 75th Cong., 1st Sess. (hereinafter, "House Hearings"). H.R. 6439 was later amended, reintroduced and reported as H.R. 8046.

> The new system which is needed must afford not only a shield but a sword for bona-fide investors and their representatives.

In the witness' view, the "keystone" to the new system was the creation of an independent reorganization trustee (*id.* at 165).

Finally, the critical role of the reorganization trustee with respect to the protection of public investors was emphasized in the House Report on what became the Chandler Act (H. Rep. No. 1409, 75th Cong., 1st Sess., pp. 43, 44):

> There must be power and responsibility in the hands of a qualified representative of investors. Otherwise disorganization may result. Investors must be afforded a "focal point" for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest. * * *.
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> * * * * *
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> This shift in power, inherent in the device of an independent trustee, is basic and fundamental if the reorganization system is to be reconstituted in the interest of investors.

2. In response to this demonstrated need to protect investors by assuring them of a vigorous and faithful trustee under the indenture pursuant to which their securities were issued and by providing them with an independent reorganization trustee who would jealously guard and pursue their rights in the reorganization process, Congress enacted Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, and, one year later, the Trust Indenture Act of 1939, 15 U.S.C. 77aaa, *et seq.*

The Trust Indenture Act contains numerous provisions governing the content of trust indentures with respect to the qualifications, duties and powers of the indenture trustee.[8] With respect to the rights of the holders of securities issued under the indenture, the Act empowers the indenture trustee to sue and recover judgment from the issuer of the securities in the event of a default in the payment of principal or interest and to file claims in any judicial proceedings affecting the issuer or its property (Section 317(a); 15 U.S.C. 77qqq(a)). In addition to its powers under the Trust Indenture Act, the indenture trustee is authorized under Chapter X to institute an involuntary reorganization proceeding against an issuer (Section 126, 11 U.S.C. 526), to file claims on behalf of its security holders (Section 198, 11 U.S.C. 598) and "to be heard on all matters" in the reorganization proceeding (Section 206, 11 U.S.C. 606). See also Sections 171, 180 and 242(1), 11 U.S.C. 571, 580 and 642(1).[9]

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[8] The Act provides, for example, that the indenture must provide for the disqualification of the trustee if he acquires certain conflicting interests (Section 310(b), 15 U.S.C. 77 jjj (b)); must require the trustee to examine all evidence furnished to it to determine whether it conforms to the requirements of the indenture (Section 315(a), 15 U.S.C. 77ooo(a)); must require the trustee to use due care (Section 315(c), 15 U.S.C. 77ooo(c)); and cannot contain exculpatory provisions, save in limited situations (Section 315(d), 15 U.S.C. 77ooo(d)).

[9] While Congress gave indenture trustees a considerable role to play in Chapter X proceedings, it also gave the reorganization court strong measures of control over their activities. See Sections 211-213 of Chapter X, 11 U.S.C. 611-613.

The individual upon whom investors must rely primarily for the protection of their rights in reorganization proceedings, however, is not the indenture trustee, but the reorganization or Chapter X trustee. The Chapter X trustee, who must be disinterested (Sections 156, 158, 11 U.S.C. 556, 558), is given broad powers. He must, for example, at the direction of the reorganization court, conduct a thorough investigation into the affairs of the company undergoing reorganization and report to the court any facts pertaining to fraud or misconduct and any causes of action available to the estate (Section 167, 11 U.S.C. 567). The reorganization trustee is also charged with the responsibility of formulating a plan of reorganization (Section 169, 11 U.S.C. 569).

The importance of these powers has been stressed by the courts. See *e.g.*, *In Re South State Street Building Corporation*, 105 F. 2d 680, 682 (C.A. 7). Where, as here, there are allegations of gross dereliction of duty, the trustee is required to make an investigation "of the most complete and thorough-going character." *Committee* v. *Kent*, 143 F. 2d 684, 686 (C.A. 4). Opportunities for recoveries on causes of action may have been overlooked by the management of the corporation, either out of negligence or out of a desire to conceal its own wrongdoing. Indeed, breaches of trust by an indenture trustee may never come to light until the debtor is undergoing reorganization and a thorough independent investigation is made.

In addition to the powers and duties specifically enumerated in Chapter X, the Chapter X trustee is

also given the same rights and duties as a trustee appointed in ordinary bankruptcy proceedings (Sections 186, 187, 11 U.S.C. 586, 587). Thus he is vested with title to specified classes of the debtor's property, including various causes of action (Section 70a of the Bankruptcy Act, 11 U.S.C. 110(a)) and given rights to manage the property, reduce the property to money and close up the debtor's affairs (Section 47, 11 U.S.C. 75).

Finally, beyond the specifically enumerated rights and the rights incorporated by reference, it is standard procedure that the Chapter X trustee be given in his order of appointment[10] "such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor," to the extent not inconsistent with the other Chapter X provisions (Section 187 of Chapter X, 11 U.S.C. 587). Such additional rights and powers were given to petitioner in this case (App. 44a).

3. In assessing the scope of the Chapter X trustee's powers and duties, it is necessary to keep in mind that the essential purpose of a Chapter X reorganization is not, as in other bankruptcy proceedings, to afford a bankrupt an opportunity to be discharged from its debts, but is to provide investors and creditors with an effective method of protecting their

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[10] In a Chapter X proceeding, the district court is invested, in addition to numerous specific powers, with all the powers of a court presiding over a receivership in equity, to the extent such powers are not inconsistent with the other provisions of Chapter X (Section 115 of Chapter X, 11 U.S.C. 515).

interests. This concept was stressed in Commissioner Douglas' testimony before the House Judiciary Committee (House Hearings, p. 172):

> Under the new act the legal concept of the debtor is not carried completely into the statute. It is the investor concept all the way through. What does the debtor mean? The debtor, practically, as distinguished from legally, means nothing more nor less than the old management. * * * We are looking at it from the viewpoint of the investors' interest in these estates.

Thus, for example, there is no legal impediment to a reorganization under Chapter X on account of the misconduct of the debtor corporation,[11] since the statute seeks to protect the rights of the debtor's creditors and stockholders as against, *inter alia*, the wrongs of the debtor's former management. In this perspective, the entity undergoing reorganization is not merely the debtor corporation, but is essentially the collection of classes of creditors and stockholders who are arrayed, for purposes of participating in a plan of reorganization or for receiving a distribution of assets of the corporation, in a hierarchical order in accordance with their legal priorities. Accordingly, a Chapter X trustee's lawsuit "on behalf of the estate" becomes, in reality, on behalf of that class of creditors or stockholders who will happen to benefit from any recovery.

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[11] By way of contrast, a bankrupt in ordinary bankruptcy may not receive a discharge of all or some of his obligations if he has been guilty of certain acts (Sections 14(c) and 17(a), 11 U.S.C. 32(c) and 35(a)). See also Section 366(3), 11 U.S.C. 766(3).

B. The Chapter X Trustee Is the Appropriate Person to Enforce the Rights of Debenture Holders Against an Indenture Trustee

In view of the focus in Chapter X reorganization proceedings on the public investors rather than on the debtor itself and Congress' preoccupation with the protection of those investors, the Chapter X trustee is the appropriate person to bring an action on behalf of debenture holders against an indenture trustee for breach of its fiduciary obligations. The facts giving rise to such a cause of action will often be complex and difficult to uncover. The Chapter X trustee, with his powers of investigation under Section 167 of Chapter X, 11 U.S.C. 567, is in the best position to discover and assemble the relevant facts and present them in one suit on behalf of all members of a given class of investors.[12] Left to his own resources, the individual security holder may be wholly ignorant of his rights, or be unable to ascertain the relevant facts or enforce his rights.

The advantages of giving the reorganization trustee standing to pursue claims against an indenture trustee are well illustrated by this case. Apart from peti-

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[12] See *In the Matter of Manufacturers Credit Corporation v. Securities and Exchange Commission*, 395 F. 2d 833, 842 (C.A. 3), where the court, in comparing advantages to public investors to be found in Chapter X against their position in a proceeding under Chapter XI of the Bankruptcy Act, noted that actions for "potential remedies which the Securities Act of 1933 may afford innocent investors against those from whom they purchased the notes * * * and for others, which may be disclosed by his investigation, can be more effectively prosecuted by a Chapter X trustee than by the individuals concerned."

tioner's actions, three other suits have been filed against Marine on behalf of debenture holders—two state and one federal. These cases face uncertain futures.[13] Moreover, even if the private cases were successfully prosecuted to judgment, there could still be—in the words of Judge Kaufman, dissenting below (App. 101a)—"a massive redundancy of fact-finding."[14] For in this case, the reorganization court will have to consider fully petitioner's allegations against Marine even if the decision below is affirmed, since petitioner was permitted to interpose his claims as objections to Marine's claim for services (see p. 8, *supra*).

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[13] In one of these suits, *Lewis* v. *Marine Midland Grace Trust Co.*, New York Law Journal, June 28, 1968, p. 12, col. 2, the class action brought on behalf of Webb & Knapp debenture holders was dismissed on the ground that a class action in New York may not be prosecuted on such claims under the rule of *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept.), affirmed, 284 N.Y. 726, overruled in part by statute. Laws, 1950, ch. 812, N.Y. Personal Property Law 41.4. In a second state court action brought by a different debenture holder, the *Elkind* rule was rejected and the class action was allowed to be continued. *Ray* v. *Marine Midland Grace Trust Co.*, New York Supreme Court, New York County, Index No. 2159-1967, Jan. 8, 1971. Marine is appealing from that decision. A similar action, pending in the United States District Court since 1968, *Lewis* v. *Marine Midland Grace Trust Co. of New York*, 68 Civ. 1764 (S.D.N.Y.), has not moved forward. A motion to dismiss the complaint by Marine and other defendants is pending and discovery has not yet commenced.

[14] This redundancy could possibly be ameliorated through the application of the principles of collateral estoppel or *res judicata*. See *Blonder-Tongue Laboratories, Inc.* v. *University of Illinois Foundation*, 402 U.S. 313, 333. See also *Katchen* v. *Landy*, 382 U.S. 323, 334.

That the reorganization trustee could be a suitable representative of public investors in pursuing their claims against an indenture trustee, can hardly be doubted. As we have noted, his independence is guaranteed by statute (Sections 156, 158, 11 U.S.C. 556, 558) and his investigatory powers are broad (Section 167, 11 U.S.C. 567). The attorneys representing him must also be disinterested (Section 157, 11 U.S.C. 557). To deny that the trustee and his attorneys will vigorously and effectively represent public investors is to reject the whole concept of Chapter X reorganizations and their focus on the interests of investors.

C. In Denying Petitioner Standing, the Court of Appeals Construed the Powers of the Chapter X Trustee Unduly Narrowly and Failed Properly to Assess the Impact of Recovery Here on the Reorganization Process

1. In following its earlier decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, and holding that petitioner lacks standing to assert the claims of debenture holders against Marine, the court below stressed its view that the claims did not concern "property" of Webb & Knapp within the meaning of the Bankruptcy Act (App. 93a-94a). In our view, the court gave an unduly narrow construction to the relevant provisions of the Bankruptcy Act and drew artificial distinctions between claims which a Chapter X trustee could assert against indenture trustees and those he could not.

With respect to the Bankruptcy Act, the court stressed the provisions listing particular types of

debtor property to which the trustee acquired title (Section 70a, 11 U.S.C. 110(a)) and specifying the power of the trustee to collect and reduce to money such property (Section 47, 11 U.S.C. 75), and concluded that "nothing in the statute allows him to collect any moneys or other property not owed to or owned by the estate * * *" (App. 93a). Section 187 of Chapter X, 11 U.S.C. 587, however, expressly gives the trustee, when, as here, authorized by the reorganization court, the powers of a receiver in equity.

The broad scope of the powers of a receiver in equity have been recognized by this Court. In *McCandless* v. *Furlaud*, 296 U.S. 140, an equity receiver of an insolvent company was held to possess the requisite capacity to sue the promoters for defrauding *creditors* of the company. Mr. Justice Cardozo noted (296 U.S. at 160-161):

> A court of equity has taken hold of the assets of this company, intangible assets as well as tangible, for administration as a trust in accordance with equitable principles. * * * Included in those assets are monies fraudulently diverted to the prejudice of creditors. * * * There is power at the instance of the receiver to bring them back into the trust * * * [citations omitted].

Thus, as highlighted by the dissent in that case, the Court held in essence "that, if individual creditors have at the date of the receivership their own causes of action against third parties for fraud or misrepresentation, upon the appointment of a receiver these

causes of action are assigned in law to the receiver" (296 U.S. at 173-174).[15]

In concentrating on the various classifications of debtor property, the court of appeals gave insufficient attention to the essential purposes of Chapter X reorganizations—to provide investors and creditors with a tool for protecting their interests and to promote the development of a comprehensive reorganization plan. As we have noted (pp. 18-19, *supra*) Chapter X was designed throughout with "the investor concept" in mind (House Hearings, p. 172).

2. The decision below represents a step backward in the recognition of the Chapter X trustee's broad role in the reorganization process. The harsh rule announced in *Clarke* had in effect been limited, before being reaffirmed below, by a subsequent opinion of Judge Learned Hand (who vigorously dissented in *Clarke*) in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (C.A. 2), certiorari denied, 346 U.S. 835, holding that a Chapter X trustee had standing on behalf of certain bondholders to sue an indenture trustee for failure to pursue a guarantee of a defaulted mortgage pledged by a debtor as collateral for the bonds. In a similar decision, the Third Circuit held in *In re Solar Manufacturing Corp.*, 200 F. 2d 227, certiorari denied, 345 U.S. 940, that a

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[15] For a discussion of the powers of an equity receiver to sue on behalf of creditors, as disinguished from the corporation itself, see Note, *Power of Receiver for Corporation to Assert Causes of Action Vested Solely in Creditors*, 46 Yale L.J. 1229; and Note, *Corporations, Rights of Creditors of Insolvent Corporation—Greater than Rights of Corporation*, 34 Mich. L. Rev. 1196.

Chapter X trustee could assert the claims of debenture holders against the indenture trustee for failure to earmark certain funds of the debtor for the debenture holders as required by the indenture.

The court below sought to distinguish both *Prudence-Bonds* and *Solar* on the theory that the Chapter X trustee in each case was asserting a claim to a part of the trust "res."[16] The court recognized that, if Marine had held property of Webb & Knapp through a pledge or as the result of payments into a sinking fund, petitioner would have standing to sue (App. 91a). The above distinctions are unpersuasive and have no basis in logic or policy.

In each of the three cases—*Prudence-Bonds*, *Solar* and the instant case—the Chapter X trustee's primary concern in attempting to sue the indenture trustee was to protect the interests of the public investors; in each case, recovery was sought from the indenture trustee for the benefit of the bondholders and the issue was whether the indenture trustee had

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[16] In *Prudence-Bonds*, the indenture trustee had had possession of the mortgages pledged by the debtor, and the guaranty to pay defaulted principal and interest on the mortgages was considered as part of the "res." But, as noted in the dissent below (App. 99a), the action in *Prudence-Bonds*, as here, was one for an accounting for the loss to the bondholders that resulted from the indenture trustee's breach of duty and was not an action for restoration of the trust fund or the debtor's property. Similarly, although the court in *Solar* described the cause of action there as "quasi in rem for the benefit of the trust" and "for the restoration of trust funds," 200 F. 2d at 332, the suit was brought by the Chapter X trustee for the benefit of the debenture holders to whom the indenture trustee owed a fiduciary duty.

been "derelict in his duties" (see Judge Learned Hand's dissent in *Clarke*, 137 F. 2d at 802). To permit recovery only when the alleged breach of duty can be traced to property which at one time had been in possession of the indenture trustee is to draw an artificial line between groups of investors—protecting those on one side but not the other. The Bankruptcy Act, however, was intended to benefit all classes of creditors. See *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 114.

3. The court of appeals also relied on the ground that even a complete recovery by petitioner on behalf of the debenture holders would not materially affect the reorganization process (App. 91a-92a). In the court's view, other creditors and stockholders would not benefit from such recovery, since "[a]s a result of subrogation Marine would simply be substituted for the debenture holders as the claimant" against the estate of Webb & Knapp (App. 92a).[17] But it is by no means clear that Marine could benefit from subrogation, since, as this Court long ago pointed out in *Memphis and L.R.R.* v. *Dow*, 120 U.S. 287, 301-302:

> The right of subrogation is not founded on contract. It is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice; and is independent of any contractual relations between the parties.

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[17] The court failed to note that its conclusion would be equally applicable to an action which would be permitted under the rationale of the *Prudence-Bonds* decision.

The same view has been reiterated in subsequent cases. See, *e.g.*, *A. Gusmer, Inc.* v. *McGrath*, 196 F. 2d 860, 862 (C.A.D.C.). The reorganization court is a court of equity, see, *e.g.*, *Securities and Exchange Commission* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 455, and thus would have to balance any claims asserted by Marine through subrogation against claims of other creditors who might have assumed, to their detriment, that Marine was diligently performing its duties under the indenture. Grossly negligent conduct comparable to the conduct with which Marine is charged here has been held sufficient to preclude a party from asserting the equitable doctrine of subrogation. See, *German Bank* v. *United States*, 148 U.S. 573; *A. Gusmer, Inc.* v. *McGrath*, *supra*.[18]

Even if Marine were entitled to full subrogation so that other creditors would not benefit as a result of recovery by the debenture holders, however, it does not follow that the reorganization process would not be materially affected by such recovery. In the first place, satisfaction of the debenture holders' claims is, we submit, an integral part of a Chapter X reorganization. As we have shown, the legislative history of Chapter X makes clear that Congress intended the reorganization trustee to vigorously assert the interests of the public investors. See *In re Solar Manufacturing Corp.*, *supra*, 200 F. 2d at 333.

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[18] Indeed, in *Clarke*, the court of appeals acknowledged that an indenture trustee's behavior "may be found to preclude * * * subrogation" to the claims of debenture holders in the course of reorganization. 137 F. 2d at 801.

There is no requirement that the trustee pursue only those actions which benefit all creditors, rather than a particular class of creditors such as debenture holders. Indeed, as a practical matter, any recovery by a Chapter X trustee on behalf of the estate will often benefit only a single class of the debtor's security holders.

In any event, the other creditors would be in no worse position if petitioner successfully prosecutes his claims against Marine[19] and the debenture holders would be in a better position, since they might receive as much as one hundred cents on the dollar instead of the fraction of that amount which they may receive in the reorganization.[20] Moreover, the fate of a substantial body of public creditors—the debenture holders—may be a critical factor in developing a successful reorganization plan, for, as Judge Kaufman pointed out in his dissent (App. 99a-

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[19] The burden on the estate of litigating the debenture claims would appear to be minimal, for petitioner would have to prove the same facts in his objection to Marine's claim for services (see p. 21, *supra*).

[20] A plan of reorganization has been submitted by petitioner to the reorganization court. At hearings on the plan, petitioner submitted evidence showing that the estimated value of Webb & Knapp's remaining assets was approximately $5,500,000, whereas its liabilities aggregated approximately $31,300,000, of which $27,700,000 represented unsecured claims. It would thus appear that, after deducting an estimated $900,000 for the expenses of administering the estate, the unsecured creditors, including the debenture holders, would receive approximately 4 cents on the dollar under the plan. See the Commission's Memorandum on the Trustee's Proposed Plan of Reorganization, pp. 3-4, 15-17 (filed in the reorganization court on January 27, 1972). We are lodging a copy of this memorandum with the Clerk of this Court.

100a), recovery by the debenture holders could have a substantial effect on the view of interested parties and the court in negotiating and considering an overall reorganization plan.

4. The majority below stated that petitioner, even if granted standing, could not ultimately prevail on its claims against Marine until the results of the reorganization became known, since only then could the damages of the debenture holders from Marine's alleged misconduct be ascertained (App. 92a). In our view, however, such a delay in recovery is not necessary and any resultant uncertainty as to the actual amount of damages suffered by the debenture holders should be resolved in their favor and against Marine. As Judge Frank noted in *President and Directors of Manhattan Co.* v. *Kelby*, 147 F. 2d 465, 476 (C.A. 2):[21]

> * * * [W]here one has committed a wrong which renders impossible the exact ascertainment of damages, "the risk of the uncertainty should be thrown upon the wrongdoer instead of upon the injured party. * * *" *Story Parchment Co.* v. *Patterson Parchment Co.*, 282 U.S. 555, 563 * * *. We should not indulge in conjectures to lighten the burdens of * * * [a wrongdoing trustee] at the expense of its beneficiaries.

[21] In that case, a bank had wrongfully permitted withdrawals from a fund maintained by it for the benefit of certain bondholders and the court required the bank, as trustee, to replenish the fund notwithstanding the fact that it could never be known with precision what the bondholders' positions would have been had the improper withdrawals not been made. 147 F. 2d at 476-477.

If there were subrogation, Marine might, upon ultimate distribution under a reorganization plan, recover part of any damages paid to the debenture holders. In this respect, Marine is undoubtedly in a better position than most debenture holders to await distribution under a plan.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

STATUTES INVOLVED

Chapter X of the Bankruptcy Act (11 U.S.C. 501, *et seq.*) provides in pertinent part:

Section 115 (11 U.S.C. 515):

> Upon the approval of a petition, the court shall have and may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature.

Section 167 (11 U.S.C. 567):

> The trustee upon his appointment and qualification—
>
> (1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;
>
> (2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;
>
> (3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;
>
> * * * *

(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate; and

(6) shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named.

Section 187 (11 U.S.C. 587):

Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

Section 315 of the Trust Indenture Act of 1939, 15 U.S.C. 77*ooo*, provides in pertinent part:

(a) The indenture to be qualified may provide that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 314 to determine whether or not such evidence conforms to the requirements of the indenture.

* * * * *

(c) The indenture to be qualified shall contain provisions requiring the indenture trustee to exercise in case of default (as such term is defined in such indenture) such of the rights and powers vested in it by such indenture, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved

that such trustee was negligent in ascertaining the pertinent facts; and

(3) such indenture may contain provisions protecting the indenture trustee with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of the indenture securities at the time outstanding (determined as provided in subsection (a) of section 316) relating to the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture.

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